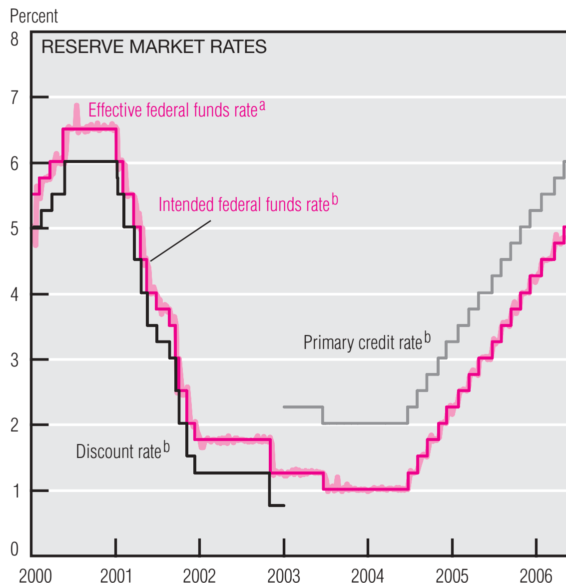
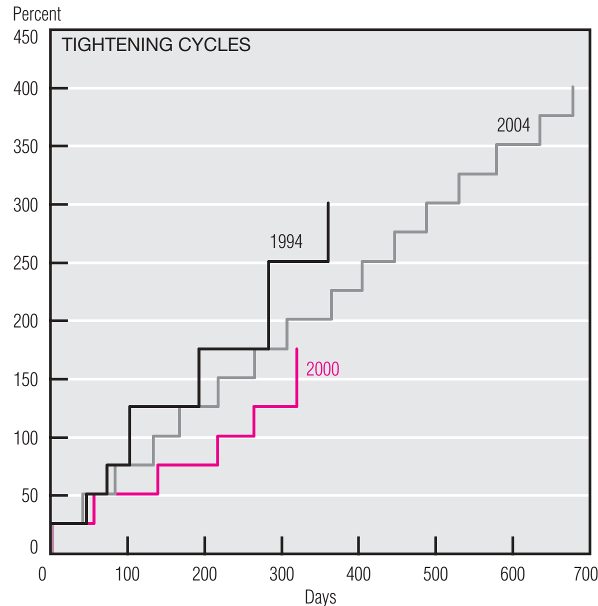
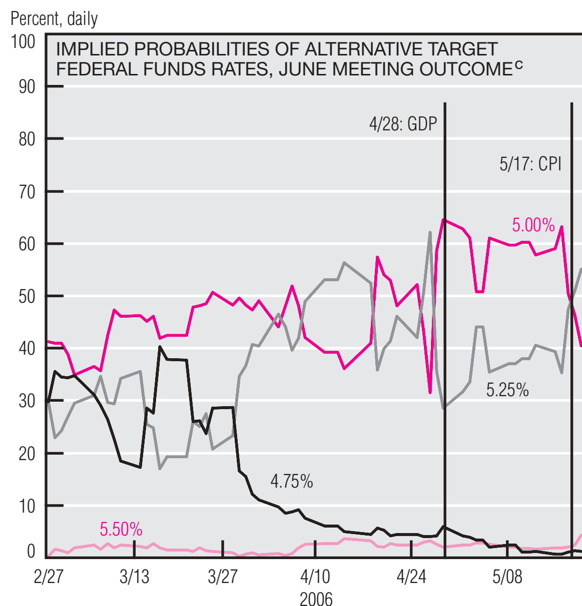
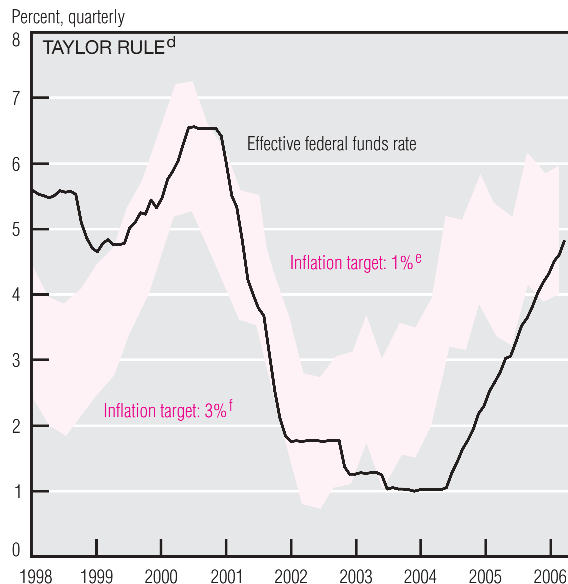
Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on June 2006 federal funds futures that trade on the Chicago Board of Trade.
d. The formula for the implied funds rate is taken from the Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy, vol. 39 (1993), pp. 195-214.
e. This line assumes an interest rate of 2.5% and inflation target of 1%.
f. This line assumes an interest rate of 1.5% and an inflation target of 3%.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

On May 10, the Federal Open Market Committee (FOMC) voted to raise the intended federal funds rate 25 basis points (bp) to 5.00%. That move brought the rate within 150 bp of its most recent high, 6.50%, reached at the last business cycle peak in May 2000. Although the May 2006 press release stated that "some further policy firming may yet be needed," it emphasized that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information."

The May meeting marked the sixteenth consecutive increase of 25 bp by the FOMC, raising the fed funds rate a total of 400 bp from its low of 1% in June 2004. Although this tightening cycle has brought a larger total increase than the previous two, it has also lasted much longer (679 days). In comparison, the 2000 tightening cycle brought a rise of 175 bp over 321 days, and the 1994 cycle increased the target 300 bp over 362 days.

Since the beginning of April, the expected outcome of the June meeting has alternated between 5.00% and 5.25%. After the GDP report on April 28, participants in the federal funds options market seemed to settle on a 60% probability of a pause at the next meeting. However, the CPI report released on May 17 sparked fears of inflation and another 25 bp increase in the fed funds rate. Currently, the odds of a further rate increase are 55%.

The Taylor rule views the federal funds rate as reacting to a weighted average of inflation, target inflation, and economic growth. According to

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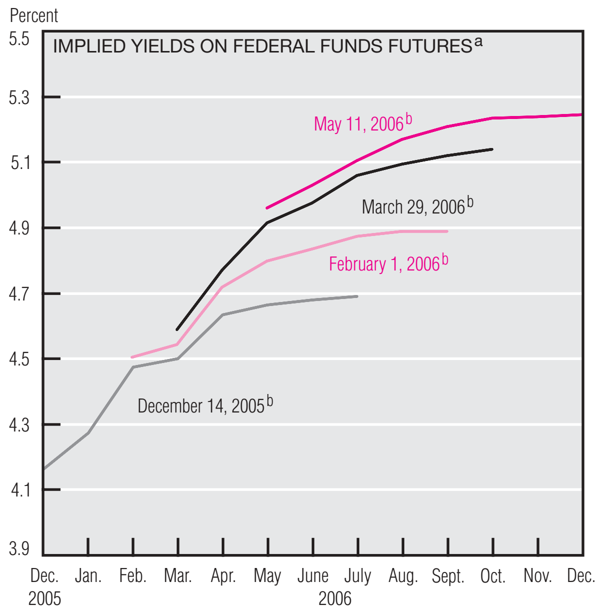

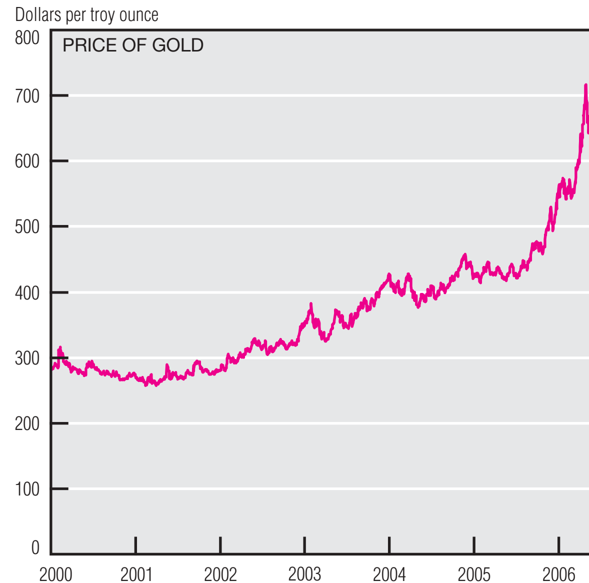

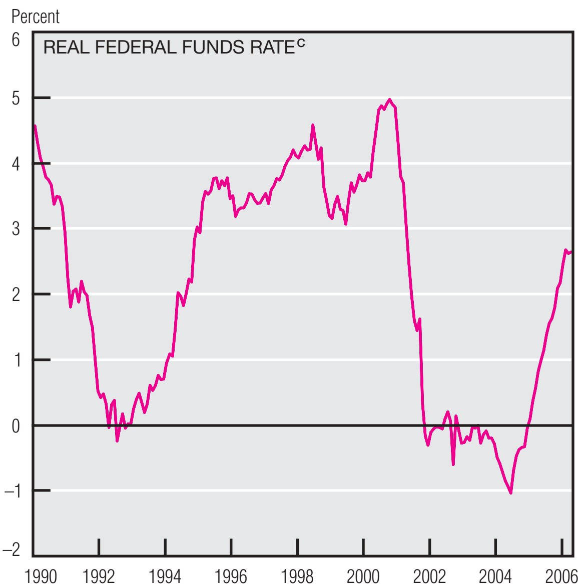

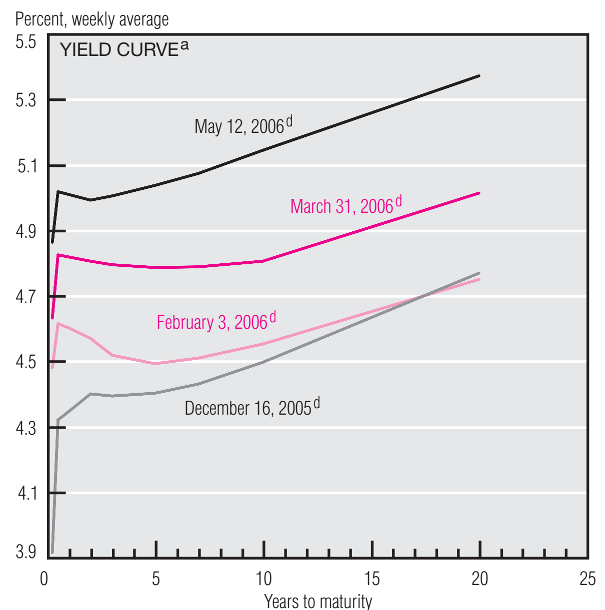

a. All yields are from the constant-maturity series.
b. One day after the FOMC meeting.
c. Defined as the effective federal funds rate deflated by the core PCE.
d. The Friday after the FOMC meeting.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

this equation, the current federal funds rate is well within its recommended range.

Consistent with the options data, participants in the federal funds futures market expect that the FOMC will pause soon and that rates will reach a plateau near 5.25%, remaining there through the end of the year. However, after the December 2005 meeting, participants were expecting rates to be between 4.50% and 4.75%. Given that the federal funds futures market has recently been underpredicting rates, the 5.00% estimate for the rest of 2006 may be a bit low, especially considering the most recent inflation report.

After increasing slowly but steadily for more than four years, the price per ounce of gold has jumped an astonishing 150% since August 2005. Historically, the price of gold has tended to increase with inflationary expectations, so its recent leap has caused some to wonder how much higher the FOMC may have to raise rates. Although the nominal federal funds rate has increased in an effort to curb any inflationary pressures, the inflation-adjusted federal funds rate has also continued to rise and now stands 365 bp above its recent low of –1.07% in June 2004.

After a period earlier this year, when parts of the Treasury yield curve were inverted, the curve has returned to normal, with long-term rates once again higher than shorter-term rates. On the Friday after the FOMC's May 10 meeting, the spread between the 10-year Treasury bond and the two-year Treasury note was 15 bp, compared to –1.6 bp after the February meeting. Although positive again, the spread remains below its historical average of 74 bp.